

M e m o r a n d u m**120.3050**

To: Mr. J. W. Cornelius MIC: 49
Audit Program Manager

Date: June 23, 1997

From: Sophia H. Chung
Tax Counsel

Subject: Custom Computer Programs
R--- B--- (SR -- XX-XXXXXX-010)
M--- A--- P--- & S--- C--- (SN -- XX-XXXXXX-010)
M--- E---, Inc. (SR -- XX-XXXXXX-010)

Your memorandum dated April 17, 1997, addressed to Mr. Gary J. Jugum, Assistant Chief Counsel, has been referred to me for response. You state that the issue of exempt sales of custom computer programs was introduced by management during settlement discussions with the above-referenced taxpayers. Although this issue was not raised by the taxpayers, based on the legal opinion dated March 25, 1997, which concluded that persons who create and transfer designs in machine readable form to operate embroidery machines are performing custom computer programming if the designs are prepared to the special order of the customer, it was decided that the settlement staff would attempt to determine if the taxpayers' products would also qualify as exempt sales of custom computer programs.

You state that the referenced taxpayers are engaged in the business of grading, sizing, and marker making for the garment manufacturing industry. Grading and sizing involve adjusting the size to scale for different size garments for each of the components of the prototype garment. Marker making is determining the most efficient way for a manufacturer to cut raw cloth to minimize losses to scrap. The taxpayers perform their design work using computer software. The finished product is downloaded on diskettes and then transferred to their customers.

You further state that the settlement staff has examined the audit work papers and held discussions with the taxpayers. The settlement staff concluded that there appears to be similarities with respect to embroidery machines and grading, sizing, and marker making machines. In both instances, product designs are downloaded on diskettes and then transferred to the garment industry for use in operating the machines.

You request a legal opinion addressing whether the analysis in our prior legal opinion addressing designs transferred on diskettes used to operate embroidery machines may be extended to include designs transferred on diskettes used to operate grading, sizing, and marker making machines.

As referenced, we have recently determined that persons who create and transfer designs in machine-readable form to operate embroidery machines are performing custom computer programming if the designs are prepared to the special order of the customer. Thus, the transfer of custom designs on punched paper tapes and diskettes used to control the operations of embroidery machines constitutes exempt sales of custom computer programs under Revenue and Taxation Code section 6010.9.

Similarly, persons who create and transfer designs on diskettes which are used to operate grading, sizing and marker making machines are performing custom computer programming if the designs are prepared to the special order of the customer. Accordingly, the transfer of custom designs on diskettes which are used to operate such machines also constitutes exempt sales of custom computer programs under Revenue and Taxation Code section 6010.9.

SHC:rz

cc: Mr. Phillip E. Bishop
Mr. Robert Nunes
Mr. Gary J. Jugum
Mr. David H. Levine